THOMPSON HINE

Tax Update

February 2023

IRS Gives Real Estate Developers New Accounting Option for Common Improvements

On January 27 the IRS issued Rev. Proc. 2023-9, which provides an optional safe harbor accounting method real estate developers can use to more readily include the estimated cost of future contractually obligated common improvements in the basis of a project's individual real property units that are held for sale to determine gain or loss on the sale of those units. This method of accounting is available for tax years beginning on or after January 1, 2023.

IRC § 461 required real estate developers to *defer* adding the cost of common improvements to the basis of benefitted units until all economic performance test elements had been met. Historically, this prevented developers from reducing gains on sales of benefitted units that closed before the economic performance test was fully satisfied. Moreover, these "lost" costs were often not recoverable through depreciation.

To address this, the IRS issued Rev. Proc. 92-29, which enabled developers to obtain IRS consent to include the pro rata amount of the estimated cost of common improvements in the basis of sold properties whether or not the cost was incurred under IRC § 461 (the "alternative cost method"). While this method provided relief to real estate developers, it came with burdensome compliance requirements: developers seeking to use the alternative cost method had to file a request to do so for each project on or before the due date of the developer's original federal income tax return for the year in which the first benefitted property in each project was sold. Each request required considerable detailed information concerning the developer, each project and the applicable common improvement cost calculations.

Rev. Proc. 2023-9 eases the administrative and compliance burdens for real estate developers wishing to use the alternative cost method. The IRS acknowledged that the Rev. Proc. 92-29 process was outdated, burdensome and lacked clarity for developers using the completed contract accounting method.

Under Rev. Proc. 2023-9, electing real estate developers are required to apply the alternative cost method to all qualifying projects in a trade or business, instead of on a per-project basis, simplifying the developer's filing requirements. Adopting this alternative cost method is a change in accounting method; however, Rev. Proc. 2023-9 allows most eligible taxpayers to use the automatic change method proscribed by Rev. Proc. 2015-13 and file a Form 3115. Certain real estate developers will be eligible to file a shortened Form 3115.

Rev. Proc. 2023-9 requires that the alternative cost method be consistently applied in a reasonable manner. Real estate developers using an accrual method of accounting are "permitted to include in the basis of units sold (or make an adjustment to income with respect to units sold in prior taxable years) their allocable share of the estimated cost of common improvements … regardless of whether the costs are incurred under § 461(h), subject to the alternative cost limitation[.]"

A real estate developer that elects to use the alternative cost method calculates the estimated cost of common improvements by adding the amount of common improvement costs incurred under IRC § 461(h) as of the end of the taxable year to the amount of common improvement costs the developer reasonably anticipates it will incur under IRC § 461(h) during the anticipated time to complete the qualifying project (with a maximum time horizon of 10 years). The real estate developer then allocates the estimated cost of common improvements among all units in a qualifying project as it determines, so long as the allocation method is applied consistently and reasonably reflects the benefits provided by the common improvements.

Electing real estate developers may adjust cost estimates in subsequent years for several factors, including differences between anticipated and actual work, undertaking new legal obligations or being released from previous ones, and increases in the anticipated time horizon.

Rev. Proc. 2023-9 imposes a limitation: the sum of the estimated cost of common improvements included in the basis of all units in a qualifying project that have been sold at the end of the taxable year may not exceed the total amount of common improvement costs that have been incurred under IRC § 461(h) with respect to that qualifying project. Amounts exceeding this limitation may not be carried forward or applied to other projects.

Rev. Proc. 2023-9 also provides analogous guidance to real estate developers using a completed contract method of accounting, specifically addressing the issue of long-term contracts under IRC § 460.

Real estate developers should consider the benefits afforded by Rev. Proc. 2023-9 for 2023 and thereafter.

FOR MORE INFORMATION

For more information, please contact:

Jim Balthaser
614.469.3226
Jim.Balthaser@ThompsonHine.com

Thomas J. Callahan
216.566.5612
Tom.Callahan@ThompsonHine.com

Brian N. Mashny
216.566.5648
Brian.Mashny@ThompsonHine.com